

Tax Information for Small Business - Accounting Methods For Construction Contracts

Accounting Method: Accounting Method:

A set of rules used to determine when and how income and expenses are reported.

Income

CASH METHOD: Include all monies actually or constructively received

ACCRUAL METHOD: Include amounts when the product or service is provided

Expenses

CASH METHOD: Deduct when actually paid

ACCRUAL METHOD: Deduct when the expense is incurred

Must Use Accrual Method

- If incorporated or in a partnership with a C corporation and average annual gross receipts exceed \$5 million.
- Personal Service corporations and farm businesses can use cash method.
- Tax shelters never can use the cash method. I.R.C. § 448.

When the production, purchase, or sale of merchandise (materials) is deemed to be an income-producing factor (for example, when the cost of such exceeds a minimum percentage of the gross receipts), inventory accounting and the accrual method are required to properly reflect income, even if first requirement does not apply.

Exceptions to Second Requirement for Use of Accrual Method

1. If accrual method is not required by statute, and taxpayer is not in a prohibited class, cash method is allowed when average annual gross receipts are less than \$10 million

Rev. Proc. 2002-28

2. If taxpayer is in a prohibited class, cash method is allowed if average annual gross receipts are less than \$1 million

Rev. Proc. 2001-10

Restricted Cash Method

If the cash method is allowed for taxpayers with significant inventories of merchandise or materials due to the Revenue Procedures, the cost of purchases cannot be deducted until the merchandise is sold (“consumed”) or paid for, whichever is later.

Accrual Method

Construction contracts (I.R.C. Section 460)

The following is a text depiction of a flowchart.

Short Term or Long Term?

- If the contract is short term, then use overall accounting method.
- If the contract is long term, then choose between home contracts, or general contracts
 - If the long term contract is a general contract, then choose between small or large contractor
 - If the contractor is small, determine if the work can be completed within 2 years.
 - If contract can be completed within 2 years, then use Accrual, CCM, PCM, EPCM or Cash (unless accrual required)
 - If contract lasts longer than 2 years, then only use PCM.

Short vs. Long-Term Construction Contracts

Short-term contracts start and finish within the same tax year.

Can use cash (unless accrual method required) or accrual method.

Example: If you have a contract that starts on 12/26 and ends on 1/23 of the next year, you have a long term contract.

Homes vs. General Construction Contract

Home Construction

80% of total estimated contract costs are for construction, improvement, or rehabilitation of buildings that have four or fewer residential units.

General Construction Contracts

Large Contractor

Definition: Average gross receipts for the last 3 years was greater than \$10M.

Large Contractor must use Percentage of Completion

Method (PCM):

- Cost Comparison Method or

- Simplified Cost Comparison Method (reduced cost allocation requirements)

Small Contractor

Definition: Average gross receipts for the last 3 years was \$10M or less.

The accounting method depends on whether construction will take more than 2 years.

Small Contractor - Construction over 2 years duration

Use the percentage of completion method (PCM) for all construction over 2 years in duration.

Small Contractor - Construction Duration 2 Years or Less

As a small contractor, you can use the

- Cash (unless accrual method required)
- Accrual
- Percentage Completion Method (PCM)
- Exempt-Contract PCM (EPCM)
- Completed Contract Method (CCM)

Exempt – Contract PCM

- Any reasonable comparison of cost incurred to date with estimated total cost
- Comparison of work to date with estimate of total work required

Cost Comparison Method

- Divide job costs incurred through end of year by estimated total job costs.
- Multiply this percentage by contract price to determine Cumulative Gross Receipts (CGR) through end of year.
- Subtract the CGR calculated through preceding year from CGR calculated through current year.
- Difference is Gross Receipts figure for current year.

Example of PCM Cost Comparison Method Based on a Total Contract Price of \$1,000,000

Cumulative Costs
 Year 1 - \$200,000
 Year 2 - \$600,000
 Year 3 - \$750,000

Estimated Total Costs

Year 1 - \$800,000

Year 2 - \$900,000

Year 3 - \$750,000

Completion Factor

Year 1 - 25%

Year 2 - 67%

Year 3 - 100%

Cumulative Gross Receipts (CGR)

Year 1 - \$250,000

Year 2 - \$666,667

Year 3 - \$1,000,000

Prior Years CGR

Year 1 - 0

Year 2 - (\$250,000)

Year 3 - (\$666,667)

Current Year Gross Receipts

Year 1 - \$250,000

Year 2 - \$416,667

Year 3 - \$333,333

Work Comparison Method

- This percentage of work completed must be certified by an architect or engineer.
- Multiply this percentage by contract price for Cumulative Gross Receipts (CGR) through end of current year.
- CGR through current year less CGR through previous years produces Gross Receipts for current year.
- Divide work completed to date by estimated work needed to finish job.

Completed Contract Method

Report all income from the contract and deduct all related job costs in the year the project is completed and accepted by the customer.

Home Construction Contracts

Spec Home

Small Contractors - Spec Home Rules

Large Contractors - Spec Home Rules

Custom Built Home

Small Contractors - Accrual CCM or Cash EPCM (unless accrual required)

Large Contractors - Capitalization Rules of IRC Section 263A apply

Definitions

Homes Built for Speculation (Spec Home Rules): All direct and indirect costs are accumulated. Costs are part of the basis for the property and cannot be deducted until the home is sold.

Custom Built Home: Home built for a specific customer.

Type of Costs

- General and Administrative (G&A) Expenses
- Direct Job Costs
- Indirect Cost Allocation

General and Administrative Expenses

General and administrative expenses are the indirect costs of operating a construction business that cannot be traced to a specific job.

General & administrative expenses are deducted when incurred or paid

Direct Job Costs

Labor, materials, and subcontractor expenses can be traced directly to the construction project.

Indirect Cost Allocation

Indirect job costs involve expenses that benefit more than one job and must be allocated among all the jobs that received the benefit.

Thank You!